Why excessive aggregation “Other operating expense” in P&L?

------How are managements applying judgement? What role does the auditor play? IFRS Standards?------

12th IFRS Digital reporting Workshop

Date and time：4 Sep 2017, 18:30-20:30 (Tokyo time)

Venue: IFRS Foundation Asia Oceania office

Management's judgement on appropriate breakdown

In previous workshops, we picked up issues regarding IFRS disclosure, that result in users having to struggle with obtaining appropriate data for corporate analysis. We discussed the topic of the BS in relation with Notes at the 9th workshop (Sep, 2016); the issue of whether or not to include share of profit from associates in "operating income" in future cash-flow evaluation at the 10th workshop(Feb, 2017); and M&A disclosures at the 11th workshop (May, 2017). A common theme observed across these discussions was the perception that we need to make clear the "purpose of disclosure" to fundamentally solve these issues. Currently, the IASB is calling for comment on the Discussion Paper, "Disclosure Initiative – Principles of Disclosure." Our past discussion could be answers some questions.

This time, we pick up cases in which we examine disclosure on the expense side, and discuss with participants from diverse background what may be the cause of the issue..

Recent workshops

- 2016 Sep. 9th **What is the role of Balance Sheet? (Thinking toward PFS project)**
- 2017 Feb.10th **How "operating activities"(Main business?) should be presented?**
- 2017 May.11th **Evaluation of company's value in acquisition & ideal disclosure**

Attendees	**12th Workshop 4th September (Monday)**
Categories	9 Investors (including Pension fund), 7 Information provider/Media/Researcher, 7 Sell-side/credit analyst/insurance, 10 CPA, 5 Company side, 1 Academic, 3 Regulator/Accounting setter/Analyst organization.
Participants overseas by phone & WebEx	Investors , Regulators, CPAs from London, Korea, HK, Singapore, Thailand, Malaysia, Indonesia, Vietnam.
1st Sep Pre-session (for attendees who couldn't join 4th)	3 Investors (One of them had presentation as former preparer), 1 Sell-side, 2 Information provider/Researcher, 2 CPA, 2 IASB

CASE 1

Why are there large “Other operating expense” in P&L?

This company changed the structure of Notes to PL in securities report in FY ending March 2017 (FY2016), the 3rd year after adopting IFRS. In the FY 2015, Notes to the consolidated PL included following items listed on the left hand column as breakdown (Number stands for each Note number in securities report of that FY). The important point about breakdown of “21(1) Other income and expenses” and “21(2) Financial income and expenses” is that income and expense have separate subtotals, and are not disclosed on a net basis. Under this note structure, it is therefore possible to consistently disaggregate consolidated PL in detail.

FY 2015		FY 2016	
18	Other comprehensive invome	19	Other comprehensive invome
19	Expense of SG&A		
		20	By nature classification of income and expenses
20	Employee benefits expense	21	Employee benefits expense
21(1)	Other income and expenses		
21(2)	Financial income and expenses	22	Financial income and expenses
22(1)	Deferred taxes	23(1)	Deferred taxes
22(2)	Income taxes	23(2)	Income taxes

※ Gray sections are detail disclosure of P&L

Classification of revenue and expenses by nature related with Operating income

	Previous	This year
Revenue		
Sales	793,054	767,710
Work scrap income	1,515	1,247
Foreign Exchange gain	435	—
Gain on sales of fixed assets	2,276	314
Subsidy income	912	1,242
Other	3,574	3,969
Total	801,769	774,483
Expense		
Purchase of raw materials, stored goods and goods	345,370	348,572
Change in inventory assets	4,949	△202
Employee benefit expense	159,519	155,226
Depreciation and Amortization	48,537	48,556
Loss on disposal of fixed assets	1,473	3,989
Foreign Exchange loss	—	1,704
Impairment	51	2,341
Other	139,469	121,704
Total	699,371	681,894
Operating income	102,397	92,589

However, in the FY 2016 (right hand column on the table above) breakdown on “19 Selling and general administrative expenses” and “21(1) Other income and expenses” were removed and “20 By nature classification of income and expenses” disaggregating income and expenses included in operating profit using nature of expense method was added instead. Despite these changes, non-recurring items with significant variability such as “Loss on disposal of fixed asset”, “Impairment loss”, or “Foreign exchange loss” have been separately classified and we have not suffered from a loss of information content. On the contrary, by nature breakdown does not show line items presented in PL, which made it unable to disaggregate PL in detail that was partly possible in previous disclosure. Notable change in the consolidated PL of FY2016 is that “Other expenses” increased by 10 billion yen, but we cannot relate this change with breakdown by nature without own interpretation or deemed judgement, and this is the negative side.

Potential reasons behind the issue

- **Quality of disclosure?**
- **Possibility of misunderstanding materiality or Standards (By nature expenses)**
- **Miscommunication between investors and companies?**
- **Gap of understanding purpose of disclosure?**

■Is "By Nature" disclosure one of the cause?

By nature note table is referred from multiple line items on P&L, therefore not only "Other" item is large, we cannot see the direct linkage between items on the face and notes.

■Company does not care about "Other operating expense" being large? What is their materiality?

Did they consider breakdown information of individual items unnecessary? Why? Because of not knowing investors' views?

■What was the purpose of this company changing disclosure? How should auditor address to the company?

……..?

Large amounts presented as “Other” in By nature disclosure

Problem caused by the Standard? Or company not understanding investors needs?

Analysts generally make earnings forecasts based on profit analysis using marginal profit by separating operating expenses (COGS + SGA) into fixed costs and variable costs. Specific items such as depreciation and amortization or retirement benefit expenses can be taken from the notes, but other expense items are estimated, with reference to annual financial reports and taken into the estimation. I think the disclosure of a breakdown of “by nature of expense method” is a big step toward enhancing disclosure because it provides useful information regarding classification of fixed and variable costs.

However, in breakdown disclosure by “nature of expense” method, classification is ambiguous, and preparers may hesitate to reveal profit-loss model of their companies and not be positive toward disclosure. As a result, we observe some cases in which the amounts presented in “Other expenses” become too large. It is important to revise the Standard (IAS-1) to improve the quality of disclosure by building on best practice. In revising the Standard, it should be made clear in IAS 1.104 that additional information on the nature of expenses are “including but not limited to” depreciation and amortization expense and employee benefits expense. The breakdown of items presented under “by nature” disclosure could vary depending on each company, but it should be required hat classification of “by nature” expense items be clear, and remain consistent. Moreover, having large amounts aggregated into a single “Other” line item, as is currently observed in many cases, diminishes the usefulness of the information significantly.

IASB discussion

– From Agenda from ASAF (March, 2017)

IASB conducted an educational session with US FASB on this issue. In the session, FASB has introduced their history of addressing this issue for over 20 years. We tried many approaches to require adequate disclosures, but there are difficult problems in practice and we have not come to the point of enforcing them. One of the approaches is to classify items in P&L by function as a basis and to also have the by nature breakdown of each functional items disclosed. In short, employee benefits expense will be divided into three parts. Cost of sales, general and administrative expenses and development cost. IASB is now considering to require such disclosure. There may be opposing opinion because of difficulties in practice, but it may be impossible with progress in IT technologies.

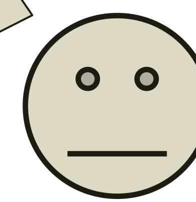
Example

TODAY	Disaggregation (by function)	Disaggregation (by nature)
Operating expenses	Cost of goods sold	Raw material Wages Depreciation
	Selling, General and Administrative expenses	Wages Rent Advertisement
	Research and development	Wages Rent Depreciation

How expense disclosure are prepared

Company S
There are accounting division at each operating department, accounting department at HQ and IR department. Each subsidiary has accounting personnel and using data connecting system, closing financial statements can be prepared at HQ level. Connecting information between accounting items at subsidiaries and parent are put into the system, therefore items which do not have connecting information in the system beforehand cannot have details acquired from HQ. Financial analysis data from each operating department are collected and summarized at HQ to present items at corporate level and adjust wording for disclosure. Sometimes we ask questions to operating department regarding analysis of operating expense, but granularity of analysis depended on operating department since they hold control of SG&A budget to some extent, and we did not step in from viewpoint of business strategy unless there is a problem with compliance. There is a wide gap between investors and accounting personnel, since communications are done at IR department of HQ, and incentive compensation for employees are based on profit.

Mitsui Co.
Each subsidiary would report using consolidated system by entering financial data by expense items set at the parent level, and items that do not fit into any of the set items are reported as “Other”. When amount reported as “Other” is too large, accounting personnel at operating department questions each subsidiary or associates to understand the details. After that, group accounting department analyzes expense, communicating operating department accountant accordingly. To be practically able to disclose by Function and by Nature as proposed, we need to further develop the accounting system.
Group accounting department prepare analysis materials at group level based on materials submitted by each accounting division, and share them to IR department. Financial data are reported to the investors in the form of Securities report or Earnings digest, but they are not prepared solely by accounting department, they are prepared by many departments including legal, IR, and accounting considering which department is most suitable for each part. Questions and demands from investors are shared by IR department to accounting department accordingly, and we consider whether or not to reflect to next FY disclosure.



Further development of IT system and synchronizing mindset of related persons are necessary to realize IASB’s proposal, which is difficult in practice.

We never know “Operating income” without knowing “Operating expenses”

■ Classification is important for both income and expense

Investors use the “Operating income” figure in many ways. Some investors overseas want to use and analyze this figure to facilitate comparisons across different entities, while others want to understand “profit from business or operating activities” and use it to estimate an entity’s future cash-flows.
From discussion of DP of improvement of Cash Flow statement which was issued by FRC. Between investors in London, FRC and IASB held in London (March 2017). （Refer to Document 9）

- ✓ We calculate EBITDA on our own to estimate the future value of a company. In the calculation, we need to separate operating figures and non-operating figures, but it is difficult to classify them. For BS , we also classify items into operating or non-operating when calculating working capital. But this is also difficult - especially separating capital expenditure.
- ✓ Current under IFRS Standards companies are not prevented from disclosing operating and non-operating items separately. If for example “lease” is main business to a company, they could disclose as operating. All the companies are trying to make similar disclosure and that is why it is becoming difficult to know difference.
- ✓ There is a way to determine operating or non-operating from CF statement, but it is difficult to reconcile between CF and PL in the current IFRS FS. One of the reason is inconsistency in classification of line items such as dividend or interest.

IASB have tried to define operating profit many times in the past. However, the results have not been necessarily positive. The reason is that operating profit differs depending on the business situation of each company, so simply defining operating profit by account items is actually useless. Rather than defining operating profit, we are considering to take in the indicator that management actually uses as a management performance major (MPM) in P&L. On the other hand, we will require EBIT to be presented as a required item. This is to require as an anchor point for comparison, and the aim is to improve the usefulness of P&L with both MPM and EBIT. However, regarding EBIT, it is difficult to define financial expense and we are trying to sort this out correlating to the capital structure. How to deal with retirement benefit liabilities, decommissioning costs or interest expenses of long-term reserves are particularly difficult , which would be challenging tasks.

Investor’s voice :
We cannot accept anything management presents as MPM, we want it to be at least showing recurring income from business

Importance of income from business (Operating Activities)

■ From 10th Workshop: Profit from significant associate is "Operating? or Investment?"

Kameda Seika applies J-GAAP. There are several associated companies overseas that are accounted for by the equity method, and their profit are becoming increasingly important.

Associated companies

(Million Yen)

Company Name	Inv. Ratio	Year Established	Main Business Fields
TH FOODS, INC. (USA)	46.8 %	1984	Manufacturing & selling rice crackers/snacks in USA
THIEN HA KAMEDA, JSC. (Vietnam)	30.0 %	2013	Manufacturing & selling rice crackers/snacks in Vietnam
Daawat KAMEDA (India) Private Limited (Announced to establish)	49.0 %	2017 (Expected)	Manufacturing & selling rice crackers/snacks in India

Consolidated statement of income (Abstract)

(Million Yen)

	FY2014	FY2015	Net Change
Net sales	94,849	97,316	2,467
Operating income	4,032	4,649	617
Equity in earnings of associates	935	1,371	436
Ordinary income	5,156	6,178	1,021
Net income	3,358	4,053	694

Kameda Seika is making rice crackers, a traditional snack in Japan made from the prime ingredient in Japanese cuisine.

Large funds, responsible governance (experience Retail sector)
"It is OK to be included"

Active fund targeting med-small companies
"It should be included"

Long-term concentrated investment
"Instinctively, I feel we should watch this figure to look at company's future. We could look for equity in earnings of associates, but since it is close to main business I feel like operating..."

An Information provider said,

Normally, we exclude extraordinary income/loss (one time income/expense).
Share of profit/loss of associates is excluded as well.

Reason for such treatment

- We are not trying to define alternative "operating income".
- Users need benchmark that are consistent for many years.
- We need to answer the needs of various clients.
- These items depend on treatments in the past or the fact that some items are not disclosed in every quarterly report.

Acquired In-Process R&D
Merger Expense
Disposal of Assets
Asset Write-Down
Impairment of Goodwill
Impairment of Intangible Assets
Sale of Business
Legal Expense
Restructuring Expense
Insurance Settlements
Other One Time Items

It is not that we want IASB to define operating income as information providers do, but we want clear and precise disclosure so that we can recognize the substance.

Before defining "operating activity", we want IASB to require disclosing same item consistently in the face and notes of financial statements so we could adjust certain items for analysis.

If associated company is material, share of profit of associates should be included in **operating**. When making forecast on future company performance, if not included then it may not closer to actual nor identify bad signs. I also think change in value of "cross-holding shares" should be treated as operating as well. Reason for cross-holding is usually explained as "maintaining / enhancing business relationship". So the company should have some impact on the business. Operating result of associates can be deemed to be included in MPM which IASB currently discussed, but the issue is judgement on whether or not a company is an associate. Under J-GAAP, judgement is generally made based on investment ratio (20%). But under principle-based IFRS, there is a room to judge whether an investee should be treated as an associate or investment securities, based on whether or not a company has "significant influence". It is difficult to define "significant", but cross-holding shares are held for "business policy", then shouldn't it be treated as associated company and reflect in P&L whether they are performing well or poorly. I may understand a little if it contributes to profit and grasped and managed by the company. Having cross-holding share is seen as an issue from investors, but **I may understand a little if it contributes to profit and grasped and managed by the company.**

Case2

Gap in how investors, preparers, and auditors assess "Materiality"

(Millions of yen)

	FY2015	FY2016
Liabilities and equity		
LIABILITIES		
Current liabilities		
Trade and other payables	181,577	189,501
Derivative financial liabilities	100	72,388
Other current financial liabilities	15,471	12,581
Income taxes payable	36,763	9,602
Provisions	22,615	22,284
Others	35,714	31,689
Total current liabilities	292,242	338,046
Non-current liabilities		
Non-current financial liabilities	25,513	274,090
Provisions	10,203	10,645
Deferred tax liabilities	47,272	3,809
Others	13,668	13,865
Total non-current liabilities	96,658	302,411
Total liabilities	388,901	640,458
EQUITY		
Capital stock	10,273	10,273
Capital surplus	11,524	13,070
Retained earnings	602,623	613,974
Treasury stock, at cost	△ 15,699	△ 15,633
Other components of equity	142,214	△ 47,183
Equity attributable to owners of the parent	750,937	574,501
Non-controlling interests	23,867	23,159
Total equity	774,804	597,661
Total liabilities and equity	1,163,706	1,238,119

Fast Retailing issued bond for the first time on 18 December, 2015. Total amount of debt issued that day amounted to 250 billion yen, which represented approximately 20% of total liabilities and equity. This bond issuance can be viewed as an important event for users to understand the company's financial situation. Therefore, it could be an example to think about the way of considering materiality in corporate disclosure.

30(7)"Liquidity risk management"	
Corporate bonds	249,486
Long-term borrowings (excluding current portion)	11,955
Long-term finance lease obligations	11,247
residual	1,402

When financial liabilities are relatively small as in FY 2015, this approach to classification may not be a problem. However, upon having issued very significant amounts of bonds, it would be better to present this information separately with specific line items instead of "Non-current financial liabilities.

The first reason is for financial disclosures focused on timeliness or in quarterly disclosure, only the face of financial statements or perhaps limited notes to accompany the FS is available. The company in this case does not include notes to financial instruments within its quarterly report or earnings digest. The second reason is that there are many cases in which the disclosures in the notes do not link with line items on the face of financial statements. In this example, the breakdown items of "Non-current financial liabilities" on the right column of Table 1 are taken from notes on "Liquidity risk management" and classified into BS items based on the judgement by the user, but the total amount does not match and compositions of some of the balances remain unclear. Therefore, we hope to have a clear and aligned disclosure format that does not require users' assumption.

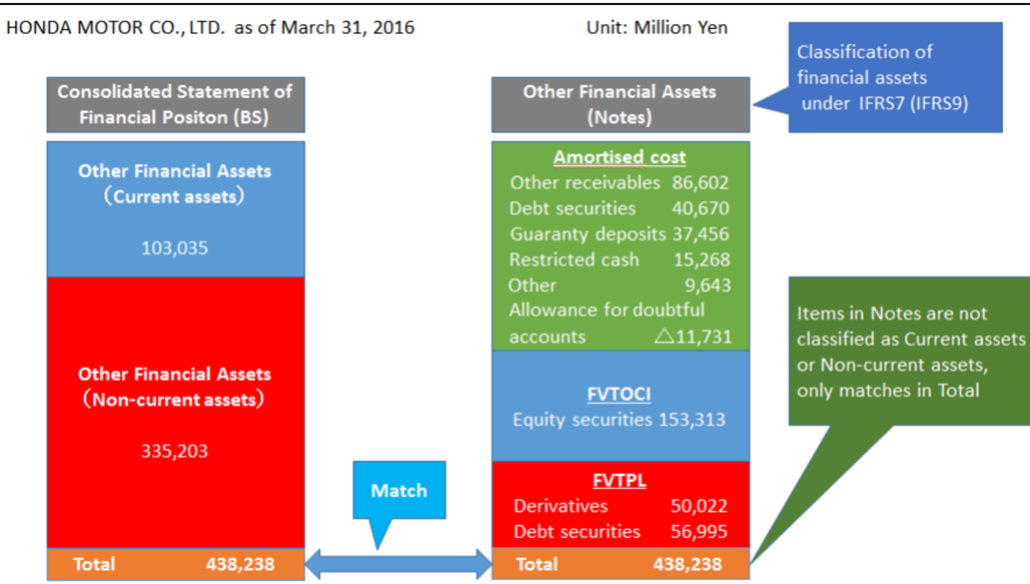
Material or Not material; Who makes the judgement?

Auditor's opinion
We are aware of the items which need to be presented other than the items specifically stated in IAS1. However, the standards are sometimes ambiguous, and it is difficult when a company claims they are in compliance with the standard. For example, IAS1.55 states that an entity shall present additional items relevant to understanding entity's financial position, but judgement on relevance can be an issue.
For P&L or BS there can be numerical threshold for materiality, but deciding to what extent should you disclose in the notes is a difficult issue. Also there is always a discussion on the disclosure of large "one-time" item, such as what to do for comparison information or what happens if an item of small number but similar nature comes up next year. There are repeated argument at site between auditor and company-side that "it should be disclosed" or "there are difficult issues if disclosed."

Regarding materiality, there is going to be Practice Statement "Application of Materiality to Financial Statements" published by the end of September. So please follow the guidance provided by IASB in this Practice Statement, though disadvantage is that it is not mandatory.

■ Per 9th Workshop

Individual items on BS do not link to each note table, breakdown is still unclear



Only "Other financial liabilities" disclosed on BS (No "Interest-bearing debts")

(Extracts from Form 6-K Second Quarter FY2016)

1. Interim Condensed Consolidated Statements of Financial Position

	(In thousands of yen) June 30, 2016
Liabilities	
Current liabilities	
Trade and other payables	18,704,889
Other financial liabilities current	43,564,606
Accrued expenses	6,205,874
Income tax payables	3,777,847
Advances received	9,503,805
Provisions current	856,004
Other current liabilities	10,975,970
Total current liabilities	93,588,995
Non-current liabilities	
Other financial liabilities non-current	202,718
Deferred tax liabilities	1,327,490
Provisions non-current	840,094
Post-employment benefits	5,394,192
Total non-current liabilities	7,764,494
Total liabilities	101,353,489

7. Financial Assets and Financial Liabilities

	(In thousands of yen) June 30, 2016 Book Value
Financial liabilities	
Trade and other payables	
Financial liabilities measured at amortized cost	18,704,889
Other financial liabilities current	
Financial liabilities measured at amortized cost	
Deposits received	1,211,568
Short-term borrowings	42,058,000
Corporate bonds	262,500
Other	32,538
Total	43,564,606
Other financial liabilities non-current	
Financial liabilities measured at amortized cost	
Long-term borrowings	202,718
Office security deposits received under sublease agreement	-
Other	-
Total	202,718

Proposal, “How to ensure effectiveness?”

Looking at IAS1 BC 55 and 56 for example, IASB recognizes that an entity may elect to disclose the results of operating activities or a similar line item, even though operating profit is not defined, and notes that the entity should ensure that the amount disclosed as representative of activities that would normally be regarded as “operating”.

Under principle-based IFRS standards, each entity defines items to be presented considering the situation of the entity, and the management decides what information to be included in or excluded from the financial statements.
As a result, except for items required in IAS 1.82 and IAS 1.54, items that are material for management are presented. Also, focusing on the notes to Other income or Other expense, “other” amount in the breakdown notes is large compared to J-GAAP

IAS 1.32 requires “An entity shall not offset assets and liabilities or income and expenses, unless required or permitted by an IFRS”, however some companies disclose on a net basis because the item is immaterial.

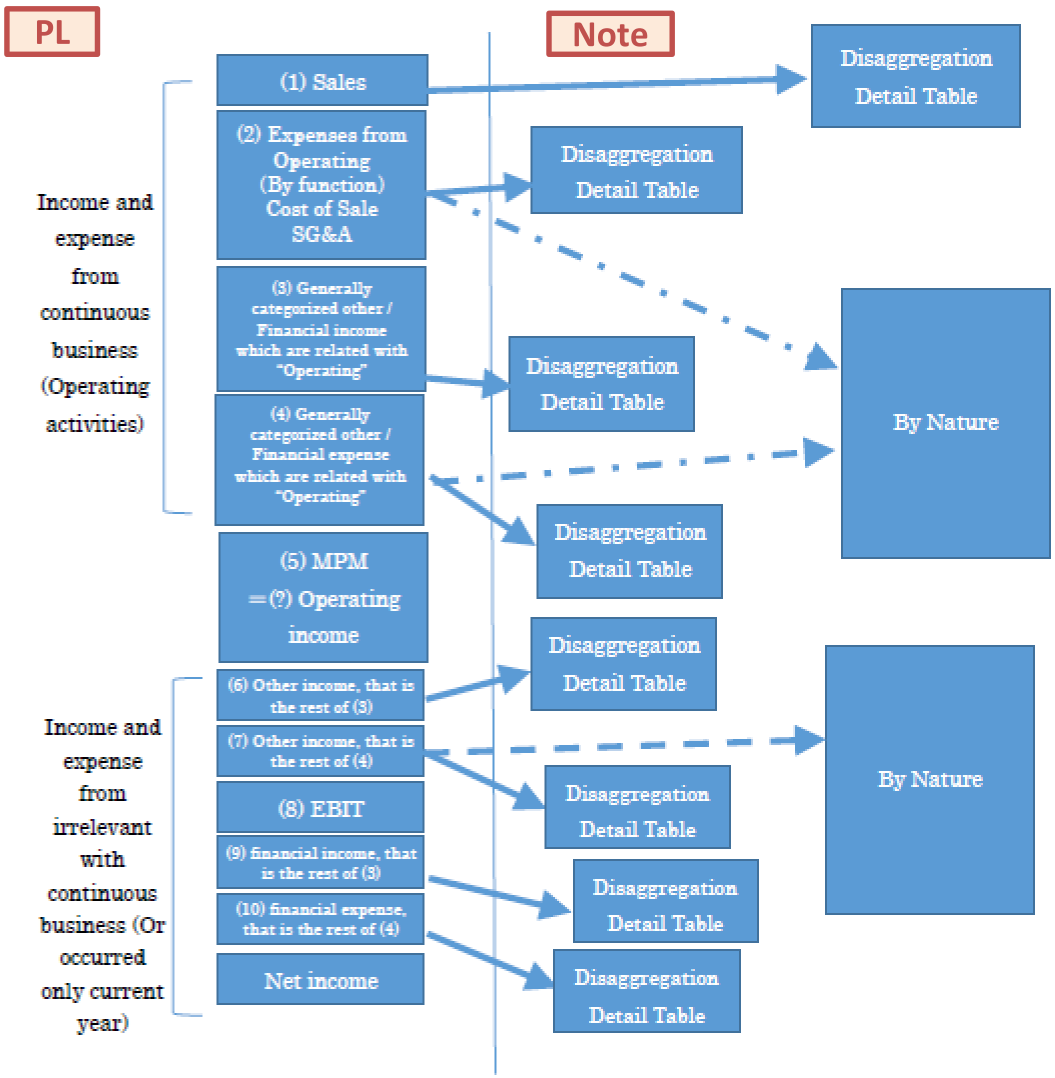
Presentation items immaterial for management do not mean they are immaterial for investors as well. Disclosure needs to be detailed enough so that investors or other financial statements users can also make same judgement on materiality from the presentation items.

Demand for Non-GAAP (unaudited) information, such as Earnings Release, Presentation materials, Transcript for Financial results presentation, Analyst Report, Management Discussion and Analysis (MD&A), is increasing more than ever corresponding to the change in financial market environment. It seems as if the weight of fundamental analysis in financial market is decreasing, but it is difficult to make appropriate investment decision without fundamental analysis. To ensure financial statements to be clear and understandable, I would think it important to define presentation item as a benchmark for management to present their business accordingly.
Defining presentation items or setting numerical requirement (threshold) are some of the possible ways to make IFRS adopting companies disclose in more details. J-GAAP adopts both ways, therefore suited for making cross company comparison.

It should take time to revise IAS 1, but by setting certain requirement on the threshold (%), it could be possible to refine disclosure under current standard. Eg: 1/10 of total (Other expense or intangible assets) to be disclosed in Notes

Currently, entities adopting by function P&L sometimes disclose some line items by nature. To improve disclosure, it is possible to cover for the downside of by function disclosure with by nature disclosure if two different statements of profit or loss are required. One is detailed by function P&L with defined presentation items and threshold requirement. The other is by nature P&L with limited items such as EBIT, EBITDA, employee benefit, depreciation and amortization, R&D, capital investment.

Would MPM work in the following structure?



- In order to analyze corporate value, investors want to know the profits gained from continuous businesses (operating). This is the motivation for requiring disclosure "Operating income".(Not only comparability) Business becomes more complex these days, it becomes difficult to understand it just seeing line-item on FS. Some are classified as financial income and loss, but they are obtained from core business. Although income from equity method companies, they are placed at core business that can not be ignored. Those are needed when predicting the future value of a company.

- The MPS that the IASB is currently proposing might not be "Operating income" in its original meaning. But what the operating income is, it should be discussed with investors and companies. If that MPM is located on PL, the classification becomes clear as shown in the figure below.

- Also, each line-item should have detail table as one to one. And when company change them they should disclose the reason. Investors can make corrections as needed, of course they can use it for "engagement" company.

What is required of the Principles of disclosure

- From the discussions it could be summarized as follows…
  - Disclosure needs to clearly show entity's business.
  - Classification of items from entity's ongoing business is important
  - If it is not possible to define "Operating income" under IFRS (principle-based) standards, we can accept MPM but MPM should be showing income from ongoing business. MPM should be defined in the Standard, though what to be included is up to each entity. It is important that MPM to be on the face of FS and within the scope of audit.
  - Disclosing breakdown of expense is difficult because of technical and cost perspective and preparers may not have the incentive. It is also difficult to understand the materiality for investors. Setting threshold may be an effective way. Threshold requirement may be set in market regulation, but there should be a practical guidance in the Standards.
  - It is important to indicate purpose in the principle, but it should not be a pie in the sky. The means of realizing the principles should also be specified.
  - Interrelation between face and notes of financial statements is important. At least face of financial statement needs to be enhanced (mote items to be disclosed) and each notes to be tied to BS and PL items one by one.
  - In practice, the role of auditor cannot be fulfilled unless written clearly in the Standards.

We are going to send those comments to IASB !!!

For Better disclosure and good communication among all related parties.

Thank you for all attendees in Tokyo and overseas!!